IV. OFFSET, DOUBLE ALLOWANCES--MITIGATION OF LIMITATIONS, AND EQUITABLE RECOUPMENT

A. Offset

"Offset" is a word of many meanings. It is oftentimes used colloquially, within the Tax Division, to refer to an adjustment in the Government's favor which reduces the taxpayer's recovery. Such an offset can only be asserted with respect to the same time period and the same kind of tax.

Conceptually, of course, this kind of adjustment is not an offset at all. It simply reflects application of a long-established doctrine--that there can be no overpayment for a year unless, taking into account all adjustments (including those as to which additional deficiencies should have been assessed), there is an overpayment for that period with respect to that tax. Lewis v. Reynolds, 284 U.S. 281 (1932).

Ideally, of course, offsets should be ascertained either by the Service, as it prepares the defense letter, or after the Trial Attorney has received the administrative files and is preparing the answer, and many times offsets are identified and pleaded timely. However, another opportunity to take a look at the case as a whole, and any computational aspect, is also presented when the Trial Attorney prepares a settlement memorandum; accordingly, it is well to keep an eye out for the possibility of offset at this juncture, also. For a refund case holding that the Government had an absolute right to assert an offset for the same taxable year, very late in the settlement review, see Americold Corp. v. United States, 28 Fed. Cl. 747 (1993).

With respect to offsets, there are various points which should be borne in mind--

(a) Never assert an offset in any case where a Form 870-AD (or any equivalent AD agreement) has been executed for the year, reserving to taxpayer the right to litigate the issue in the refund claim and complaint. 14/ To do so would be a violation of

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14/ Form 870-AD (Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment), a form used by the Appeals Office to settle cases informally, contains a promise by the Commissioner that, if the offer is accepted, the case will not be reopened by the Commissioner except in very limited circumstances, such as fraud or misrepresentation.

the Government's agreement in the Form 870-AD, and, however clear the error involved, we never assert offsets where the taxpayer's position is consistent with the Form 870-AD. However, where either Audit or Appeals has conceded all or part of an issue, the concession was erroneous, and no Form 870-AD or closing agreement was executed, an offset would be appropriate.

(b) Offsets should never be asserted when to do so would redound to the Government's disadvantage. For example, any offset involving a change to the taxpayer's method of accounting may trigger adjustments which provide tax benefits to the taxpayer (including possibly reopening years otherwise barred by limitations), which tax benefits may be far greater than the tax detriment which would result from the offset.

(c) Asserting offsets, particularly late in the game, is a rather delicate matter. The later that offsets are asserted, the greater the importance that the offsets are not only defensible, but clearly correct. Good examples are the adjustments correlative to allowance of the taxpayer's claim in whole or in part; it is very hard for the taxpayer to dispute the merits of such an offset. *See* *Americold Corp. v. United States*. Indeed, any time the taxpayer is suing on a claim which would have correlative adjustments in the Government's favor for the same year and same type of tax, were the taxpayer to prevail, it is well to plead the offset *ab initio*. Otherwise, if the case goes to judgment, and the Government loses, the Government may not be able to have the adjustment taken into account as part of the mathematical computation of the overpayment--if, indeed, the adjustment is identified at all at that point.

B. Double Allowances--Mitigation of Limitations (§§ 1311-1314) 15/

1. Sections 1311-1314--an overview

Section 1311 provides:

> (a) *General Rule*.--If a determination (as defined in section 1313) is described in one or more of the paragraphs of section 1312 and, on the date of the determination, correction of the effect of the error referred to in the applicable paragraph of section 1312 is prevented by the operation of any law or rule of law, other than this part and other than section 7122 (relating to compromises), then the effect of the error

15/ These provisions are set out as Exhibit R, *infra*.

> shall be corrected by an adjustment made in the amount and in the manner specified in section 1314.

The application of these provisions is limited to the seven narrow "circumstances of adjustment" described in § 1312. The first four circumstances involve essentially double allowances or disallowances with respect to the same taxpayer or "related" taxpayers. They are: (1) double inclusion of an item of gross income; (2) double allowance of a deduction or a credit; (3) double exclusion of an item of gross income; and (4) double disallowance of a deduction or a credit. Paragraphs (5) and (6) deal, respectively, with correlative deductions and inclusions for trusts and estates and legatees, beneficiaries, or heirs; or correlative deductions and credits for members of an affiliated group of corporations as defined in § 1504. Section 1312(7), a very complex and opaque provision, concerns basis of property after erroneous treatment of a prior transaction. 16/

Bear in mind that mitigation is applicable only if there has been a double allowance, double disallowance, etc., with respect to the same taxpayer or "related" taxpayers. Related taxpayers are defined in § 1313(c) as (1) husband and wife, (2) grantor and fiduciary, (3) grantor and beneficiary, (4) fiduciary and beneficiary, legatee, or heir, (5) decedent and decedent's estate, (6) partners, and (7) members of an affiliated group of corporations (as defined in § 1504). Although related taxpayers generally have a common economic interest, not all taxpayers with identical economic interests qualify as "related" pursuant to § 1313(c). For example, a corporation and the individual who owns 100% of its stock are not "related" under § 1313(c).

There are additional conditions necessary for § 1311 to apply, set out in § 1311(b), concerning maintenance of an inconsistent position, and correction not being barred at the time of the erroneous action.

Lastly, and of great importance in the context of settlements, a "determination" described in § 1313 which will permit relief under these provisions is specifically limited, by § 1313(a), to:

> (1) a decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;
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> (2) a closing agreement made under section 7121;

16/ *See* discussion, *infra* at pp. 53-55.

(3) a final disposition by the Secretary of a claim for refund. * * *

* * * * *

(4) under regulations prescribed by the Secretary, an agreement for purposes of this part, signed by the Secretary * * *.

2. Illustration

Let us assume that a taxpayer claims a deduction of $100,000 in 1984. On audit, the Service disallows the deduction in 1984, but allows it for 1988. Taxpayer pays the deficiency for 1984, sues for refund, and, in 1994, the taxpayer prevails and the judgment in its favor becomes final. At that time, the three-year period for assessment as to 1988 has run.

Since the taxpayer has obtained a judgment, § 1311 et seq. would reopen for one year the period of assessment for 1988, so that the Government might assess and collect the resulting deficiency. There has been double allowance of a deduction or credit pursuant to § 1312(2). The situation meets the requirement in § 1311(b)(1) that, "in case the amount of the adjustment would be assessed and collected in the same manner as a deficiency under § 1314, there is adopted in the determination the position maintained by the taxpayer * * * and the position maintained * * * by the taxpayer * * * is inconsistent with the erroneous * * * [double] allowance * * *." Further, the decision of the court which has become final qualifies as a "determination" pursuant to § 1313(a)(1).

Let us assume that the same deduction is claimed for 1984 and allowed for 1988, but the case is settled on the basis of allowance of a deduction of 50% of the amount claimed for 1984 -- or, indeed, assume that a full administrative concession is appropriate. Unless special provision is made, the Government will not be able to assess and collect the resulting deficiency for 1988 -- an Attorney General compromise or concession is not a "determination (as defined in section 1313)."

There are several ways around this problem. One is simply to provide that the deficiency for 1988 is offset against the overpayment for 1984, and make sure that the Service Center actually carries out this instruction. See discussion, supra at p. 43. The second is to make it a specific provision of the settlement that there is an agreement between the taxpayer and the Government that the settlement constitutes a determination under § 1313(a) and a correlative deficiency may be asserted for

1988, based on the partial allowance of the claim for 1984. The third is to execute a stipulation for entry of judgment as to whatever the settlement provides.

3. Pertinent considerations re applicability of the mitigation provisions

It is generally preferable to take care of any correlative § 1311 adjustment as part of a settlement rather than leaving the applicability of § 1311 to subsequent litigation.

Section 1312, which sets out the only circumstances of adjustment qualifying for relief, has not been amended to any significant extent since 1954. As stated earlier, it is very narrowly drawn. Moreover, it does not address adjustments correlative to provisions added to the Code since 1954. For example, there are no provisions dealing with the interrelationship of qualification for investment tax credit and useful life for depreciation, or the relationship between the income tax and the alternative minimum tax. For such adjustments, the Government is best served by the assertion of offsets for the same taxable year.

4. Where mitigation does not apply

Section 1311 has no application with respect to transactions between unrelated taxpayers. A corporation and an individual who owns 100% of the stock of the corporation are not related taxpayers under § 1313. Accordingly, in these situations (as well as potential § 1311 situations), the best protection for the Government is to attempt to ascertain, as soon as suit is filed, whether there are any correlative adjustments which should be made were taxpayer to prevail, to determine whether the affected years for this taxpayer or other taxpayers are still open, and, if so, to endeavor to keep those periods open. While it is certainly true that the Government can lose and has lost in litigation as to both sides of the transaction, keeping the periods open for all taxpayers involved is likely to produce a more equitable result, possibly by settlement.

C. Equitable recoupment

1. The general principle

Equitable recoupment has generally been applied in situations involving offset of one kind of tax against another kind of tax and the same taxpayer (or a related taxpayer). The doctrine has been generally described as follows (Estate of Mueller v. Commissioner, 101 T.C. 551, 551-552 (1993)):

The ancient doctrine of equitable recoupment, which developed concurrently at common law and in equity, was judicially created to preclude unjust enrichment of a party to a lawsuit and to avoid wasteful multiplicity of litigation. See generally McConnell, "The Doctrine of Recoupment in Federal Taxation", 28 Va. L. Rev. 577, 579-581 (1942). The doctrine has been applied in Federal tax matters since the Supreme Court's decision in Bull v. United States, 295 U.S. 247 (1935), to allow the bar of the expired statutory limitation period to be overcome in limited circumstances in order to prevent inequitable windfalls to either taxpayers or the Government that would otherwise result from inconsistent tax treatment of a single transaction, item, or event affecting the same taxpayer or a sufficiently related taxpayer. See also United States v. Dalm, 494 U.S. 596, 605-606 n.5 (1990); Rothensies v. Electric Storage Battery Co., 329 U.S. 296 (1946); Stone v. White, 301 U.S. 532 (1937). The doctrine of equitable recoupment may be applied to relieve inequities caused when a transaction is treated inconsistently under different taxes, such as the income tax and the estate tax. Bull v. United States, supra; Boyle v. United States, 355 F.2d 233 (3d Cir. 1965). However, the party asserting equitable recoupment may not affirmatively collect the time-barred underpayment or overpayment of tax. Equitable recoupment "operates only to reduce a taxpayer's timely claim for a refund or to reduce the government's timely claim of deficiency". O'Brien v. United States, 766 F.2d 1038, 1049 (7th Cir. 1985).

2. Estate tax-income tax interrelationships

The doctrine of equitable recoupment is most often asserted in situations involving the interrelationship of the estate tax and the income tax. Indeed, the seminal case applying equitable recoupment is Bull v. United States, 295 U.S. 247 (1935). There, income had been included as an asset of the estate for estate tax purposes, and subsequently taxed as income to the estate; in a suit for refund of the income tax which was paid on that income, the estate was allowed recoupment for the estate tax it had previously paid.

There are a great number of possible applications of equitable recoupment to estate tax-income tax situations. A common denominator of the decisions is that they are inconsistent with one another.

Although equitable recoupment is a frequent consideration in settlement, it can be addressed most effectively at the time suit is filed. If resolution of the litigation is likely to have collateral consequences with respect to other taxes, it is well to determine how the transaction was treated with respect to the other tax, and whether the period of limitations is still open, or whether there is a claim pending with respect to the other tax, and a correlative adjustment could be taken into account in resolution of that claim. If the period for making a correlative adjustment is still open, one does not have to rely on equitable recoupment--an appealing, but chancy doctrine. Moreover, to focus on correlative adjustments early (particularly if the period is open) may facilitate settlement. If, hypothetically, the estate tax refund claimed is $1,000, but the correlative income tax adjustment would be an increase in tax liability of $300, the amount at issue in the case can be more accurately measured. And, of course, the same is true if the refund suit is for income tax, but may have estate tax consequences.

One estate-income tax situation which illustrates the inconsistency of the courts in this area is that involving an estate which sues for refund of the decedent's income tax which has been paid by the estate, and deducted as a claim for income tax purposes. Compare Wilmington Trust Co. v. United States, 610 F.2d 703 (Ct. Cl. 1979) (equitable recoupment inapplicable to reduce estate's recovery of income tax deficiency by the estate tax reduction achieved by deduction of that deficiency), with United States v. Herring, 240 F.2d 225 (4th Cir. 1957), United States v. Bowcut, 287 F.2d 654 (9th Cir. 1961), and Rev. Rul. 71-56, 1971-1 C.B. 404 (estate, in unsuccessful suit for refund of income tax deficiency paid, could recover estate tax overpaid by reason of failure to deduct such taxes).

An estate's administrative expenses, as well as losses, can be claimed as deductions either on the estate tax return or on the income tax returns of the estate (or its successor(s)). These include, for example, interest incurred on the federal estate tax, payment of which is deferred under § 6166A of the Code. See Rev. Rul. 81-256, 1981-2 C.B. 183; Rev. Rul. 81-287, 1981-2 C.B. 184. And see Treas. Reg. § 1.163-9T(b)(1)(v). Similarly, attorney fees can be claimed as deductions either on the estate tax return or on the income tax returns.

To preclude the allowance of such deductions a second time (or their offset against the sale price of property in determining gain or loss), § 642(g) of the Code provides that such deductions or offset shall not be allowed for income tax purposes unless a waiver is filed of the right to claim them for estate tax purposes. There are occasions, however, when the deductions have been claimed for income tax purposes, no waiver is filed, and the statute of limitations on income tax assessments has run. In this situation, Rev. Rul. 81-287, supra, holds that equitable recoupment is applicable against a claim for refund of estate tax, where the estate seeks (or has been allowed) a double allowance.

Accordingly, in any suit by an estate seeking a refund of estate taxes and claiming deduction of the attorney fees incurred in such prosecution, ascertain whether such fees have already been deducted for income tax purposes. See Rev. Rul. 81-287, supra. In this situation, before agreeing to a deduction of attorney fees, we generally ask for an affidavit by the administrator of an estate to the effect that attorney fees have been paid and have not been and will not be deducted for income tax purposes. 17/

Probably the most typical estate-income tax situation involving equitable recoupment is the situation where the valuation or includibility of an asset in the gross estate determines basis for income tax purposes.

Again, when an estate tax case is filed, it is desirable, at this juncture, to determine if there would be any correlative income tax adjustments if the estate were to prevail. To do so, for example, one must ascertain what happened to the property in question. Is it still held by the estate, or the heirs, beneficiaries, legatees, or recipients of transfers includible in the estate? Was it sold by the estate? Was it sold by the heirs, legatees, or beneficiaries? If so, how was gain or loss reported? Is the period of limitations open or closed? We have found that oral representations that the property has been retained by the estate and/or beneficiaries may turn out to be

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17/ It is not unknown for an estate, which litigated and lost an estate tax issue in the trial court, to contend that there was error based on the nonallowance of attorney fees. One such case was conceded by the taxpayer (and the Government concession proposed was disapproved) when it was ascertained that the attorney had been hired on a contingency fee basis and was to recover nothing unless successful.

untrue when confirmation in writing is requested. For that reason, obtain written confirmation.

The Division (and, following our lead, the Service) have endeavored to address this situation by the use of collateral agreements affecting basis, executed by the present holders of the property, whether the executor or administrator, heirs, beneficiaries, distributees, or donees. 18/ Such agreements are intended to protect the Government in the situation where the estate and/or beneficiaries have not disposed of the property in a taxable transaction.

If the year in which a taxable disposition occurred is closed and additional income tax is due, the Trial Attorney should attempt to obtain a reduction in the estate tax refund equal to the additional income tax due under the doctrine of recoupment. If the year is open, the offer can provide for the filing of amended returns which are consistent with the settlement.

The income tax consequences of an estate tax determination of includibility or valuation in the estate is a situation which at least one court has addressed (incorrectly, we believe) under § 1311, as a § 1312(7) adjustment. 19/ It held that the

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18/ A sample collateral agreement re basis is attached as Exhibit S. Of course, it must be modified to suit the particular case.

19/ Section 1312(7) provides:

> (7) Basis of property after erroneous treatment of a prior transaction.--
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> > (A) General rule.--The determination determines the basis of property, and in respect of any transaction on which such basis depends, or in respect of any transaction which was erroneously treated as affecting such basis, there occurred, with respect to a taxpayer described in subparagraph (B) of this paragraph, any of the errors described in subparagraph (C) of this paragraph.
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> > (B) Taxpayers with respect to whom the erroneous treatment occurred.--The taxpayer with respect to whom the erroneous treatment occurred must be--
> >
> > > (i) the taxpayer with respect to whom the

requirements of § 1312(7) had been met, where the Tax Court had determined higher values than those reported on the estate tax return, and the beneficiaries of the estate had used the returned values for income tax purposes, with resulting barred overpayments. Chertkof v. United States, 676 F.2d 984 (4th Cir. 1982). In so doing, Chertkof invalidated Treas. Reg. § 1.1311(a)-2(b). 20/ In a similar situation, but without

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determination is made,

(ii) a taxpayer who acquired title to the property in the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, or

(iii) a taxpayer who had title to the property at the time of the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift).

(C) Prior erroneous treatment.--With respect to a taxpayer described in subparagraph (B) of this paragraph--

(i) there was an erroneous inclusion in, or omission from, gross income,

(ii) there was an erroneous recognition, or nonrecognition, of gain or loss, or

(iii) there was an erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible.

20/ The regulation provides:

(b) The determination (including a determination under section 1313(a)(4)) may be with respect to any of the taxes imposed by subtitle A of the Internal Revenue Code of 1954 ["Income Taxes"], by chapter 1 ["Income Tax"] and addressing the correctness of _Chertkof_, the Seventh Circuit held § 1311 inapplicable, on the ground, _inter alia_, that the error (the use of a lower basis) did not occur "in respect of" the basis-determining transaction, as required by § 1312(7)(A). _O'Brien v. United States_, 766 F.2d 1038 (7th Cir. 1985). Additionally, _O'Brien_ held the doctrine of equitable recoupment inapplicable, stating (766 F.2d at 1049): "The doctrine * * * operates only to reduce a taxpayer's timely claim for a refund or to reduce the government's timely claim for deficiency."

3. _Employment taxes_

Equitable recoupment has been asserted (generally without any objection by the taxpayer) where a taxpayer seeks a refund of Railroad Retirement Taxes, and, were the taxpayer to prevail, FICA taxes would be due. Section 6521 specifically provides for mitigation, _i.e._, offset, in SECA-FICA situations.

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subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code of 1939 ["Additional Income Taxes"], or by the corresponding provisions of any prior revenue act, or by more than one of such provisions. Section 1311 may be applied to correct the effect of the error only as to the tax or taxes with respect to which the error was made which correspond to the tax or taxes with respect to which the determination relates. Thus, if the determination relates to a tax imposed by chapter 1 of the Internal Revenue Code of 1954, the adjustment may be only with respect to the tax imposed by such chapter or by the corresponding provisions of prior law.